AIRMAC COMPANY GROUP CASE

GOVERNMENT/CONTRACTOR INFORMATION

The Airmac Company was awarded a fixed-price contract with the government as a result of submitting the low bid in the amount of $2,062,544. The contract required the company to convert fifteen (15) Government-furnished one-ton oxygen-nitrogen generator units to one-and-one-half ton capacity units. When Airmac did not deliver the required prototype within the time specified, the Government decided to terminate the contract for default under the provisions of FAR Subpart 49.4. Airmac elected to appeal under the provisions of the "Disputes" clause and so notified the Contracting Officer. After reviewing the facts of the case, the Armed Services Board of Contract Appeals (ASBCA) ruled that the contract be terminated on the basis of convenience of the Government rather than default on the part of the contractor. The Board remanded the matter to the Contracting Officer for settlement. The Government did not appeal the decision of the ASBCA.

Following the decision of the Board of Contract Appeals, the Termination Contracting Officer (TCO) granted Airmac permission to submit its termination settlement proposal on the total cost basis.

Determination as to the amount which Airmac Company is entitled to recover is governed by the Termination for the Convenience of the Government clause in the contract. Paragraph (h) of the clause provides that the cost principles set forth in FAR Part 31, as in effect on the date of the contract, govern cost determinations. FAR 49.201(a) expresses the philosophy to be used as guidance in determining a fair settlement:

> "A settlement should compensate the contractor fairly for the work done and the preparation made for the terminated portions of the contract, including a reasonable allowance for profit. Fair compensation is a matter of judgment and cannot be measured exactly. In a given case, various methods may be equally appropriate for arriving at fair compensation. The use of business judgment, as distinguished from strict accounting principles, is the heart of a settlement."

FAR 49.202(a) provides guidance to be used in determining allowance for profit:

> "The Termination Contracting Officer (TCO) shall allow profit on preparations made and work done by the contractor for the terminated portion of the contract but not on the settlement expenses. Anticipatory profits and consequential damages shall not be allowed. Profit for the contractor's efforts in settling subcontractor proposals shall not be based on the dollar amount of the subcontract settlement agreements but the contractor's efforts will be considered in determining the overall rate of profit allowed the contractor. Profit shall not be allowed the contractor for material or services that, as of the effective date of termination, have not been delivered by a subcontractor, regardless of the percentage of completion. The TCO may use any reasonable method to arrive at a fair profit."

The Airmac Company submitted the following proposed settlement:

Initial Termination	Settlement Proposal
Proposed Settlement	$782,669
Less Progress Payments	$117,508
Net Payment Requested	$665,161

After the TCO received the contractor's proposed settlement figures, the Government team proceeded with the task of determining allocability, allowability, and reasonableness of the dollar amounts. Every aspect of the contractor's proposal became the subject of discussion and correspondence between the TCO and representatives of the Airmac Company. The proposal was audited by the Defense Contract Audit Agency and was later examined in detail by a Government price analyst. The proceedings became so involved that Airmac engaged the services of an accounting firm to conduct a further review of the books and papers on which the proposed settlement was based. This effort resulted in a "Revised Termination Settlement Proposal." The net proposed settlement arrived at by the accounting firm amounted to $662,688 less progress payments and partial payments received by Airmac. The revised proposed settlement is shown on the next page.

Revised Termination	Settlement Proposal
Initial Settlement	$782,669
Revised Settlement	($662,688)
Difference	$119,981

AIRMAC COMPANY GROUP CASE

Revised Termination Settlement Proposal

(Portion of SF 1436 -- Settlement Proposal -- Total Cost Basis)

Direct Material	$163,550
Direct Labor	105,867
Indirect Factory Expense (109.6%)	116,030
Special Tooling & Special Test Equipment	—
Other Costs	18,750
General & Administrative Expenses (25.6%)	103,474
TOTAL COSTS	507,671
Profit (15%)	76,151
TOTAL	583,822
Settlement Expenses	78,866
TOTAL	662,688
Settlement with Subcontractors	—
Gross Proposed Settlement	662,688
Disposal and Other Credits	—
Net Proposed Settlement	662,688
Advanced, Progress and Partial Payments	117,508
Net Payment Requested	545,180

AIRMAC COMPANY GROUP CASE

GOVERNMENT CONFIDENTIAL

Direct Material

The DCAA Auditor examined the revised proposal and furnished the following comments with reference to direct material costs proposed by the contractor:

Revised Proposal

Inventory	$121,450
Freight	6,675
Consumable Small Tools	3,875
Subcontract Progress Payments	31,550
Total Direct Materials	163,550

1. Of the $121,450 inventory figure, the Auditor has questioned $6,238 of interest charges on money borrowed at 14 percent to pay for materials.

2. Also included in the $121,450 inventory figure is $15,196 of inventory which Airmac cannot locate. The Auditor took a look at the inventory shortage and, after confirming with the Contracting Officer that they could account for all of the inventory except for this amount, concluded that this was a problem for the Airmac Company and the Government negotiating team to resolve.

3. The Auditor questioned the freight charges of $6,675 as a direct material as cost since Airmac is showing other freight charges for other company contract an indirect factory expense. The Auditor recommends that the freight charges of $6,675 be transferred to indirect factory expense.

4. The Auditor also questioned charging $3,875 for consumable small tools as direct material cost. Airmac is showing other small tools for other company contracts as an indirect factory expense. The Auditor recommends that the $3,875 be transferred to indirect factory expense.

Direct Labor

Since the Airmac Company had initially claimed $150,742 as direct labor on the contract, the Auditor and the Price Analyst were asked to take a good hard look at this part of the proposal.

The Auditor found the following in regard to direct labor as submitted by the Airmac Company:

Revised Proposal

Manufacturing Labor	$62,962
Engineering Labor	25,122
Other Direct Labor	3,152
Material Handling Labor	14,631
Total Labor Cost	105,867

1. To start off the Auditor wanted to know what Airmac had originally included in the proposed settlement that resulted in a labor cost of $160,742. In checking with the C.P.A., it was found that this amount had included such items as managerial salaries, vacation, and holiday pay. The C.P.A. assured the Auditor that he had properly reclassified these costs as indirect costs to the extent possible from his review of the books.

   The Auditor then went to the Contracting Officer and learned that the Quality Assurance Representative (QAR) would be able to shed some light on the subject of labor since the QAR had information on the number of personnel who were working on the generator units. The QAR stated that observations were only casual in that no formal inspection records were kept of the actual number of workers employed. The QAR further explained that only one of the three shifts had been observed but estimated that there was close to equal effort applied to the contract by each of the three shifts.

   The TCO realized that perhaps the best approach would be to have the Auditor glean as much information as possible from the Airmac Company records.

2. The Auditor next examined the proposed engineering labor costs and was not able to directly trace the work performed by a consulting engineer in the amount of $3,427 to this contract. The Auditor did see a bill and payment made for the consulting engineer. If it can be determined that all of the work of the consulting engineer was on this contract then the costs should be allowed but allowed in "other costs" since the engineer was not an employee of the company and these efforts should not be burdened by indirect factory expense. If it appears that all of these efforts were not on this contract then the costs of $3,427 would be more appropriately allowed in either indirect factory expense or G&A expense.

3. Although the inclusion of material handling labor costs as a direct charge might seem questionable, Mr. Al Purola, President of Airmac, claimed that a separate warehouse was set aside for the purpose of handling materials associated with the project. This made it possible for Airmac to establish from payroll records of shipping clerks and receiving clerks, the material handling costs incurred solely for performance on the contract. The $14,631 represents the salaries paid to five employees and the Auditor finds these costs allowable and reasonable in light of the large number of components which were stripped from the Government-furnished units.

4. The Auditor examined the $3,152 claimed as other direct labor costs and concluded that the miscellaneous direct labor was allowable and reasonable in amount.

Indirect Factory Expense

Indirect factory expense gave the Auditor a bad time. The problem centered around the fact that the Airmac Company attempted to charge all costs directly, even those normally treated by accountants as indirect expenses. As a result, no indirect factory expenses pool was accumulated. After termination of the contract, the Auditor, Price Analyst, and the C.P.A. each attempted to accumulate pools for indirect factory expenses and general and administrative expenses. The C.P.A.'s approach was to calculate the direct labor base for the Company, calculate the indirect factory expense pool for the same period of time, and arrive at the indirect rate by dividing the labor base into the sum of the indirect factory expense pool.

The C.P.A.'s indirect factory expense pool was proposed as follows:

Quality Assurance	$ 13,871
Rent	32,584
Repairs and Maintenance	14,372
Small Tools	6,475
Utilities	21,468
Travel	6,455
Employee Welfare	3,500
Depreciation	11,449
Holiday and Vacation Pay	7,191
Indirect Labor and Materials	56,979
Auto and Truck Expense	3,395
Insurance	6,723
Indirect Freight	5,516
Taxes (Payroll, Property, etc.)	28,122
Allowance for Uncollectible Accounts	6,000
Equipment Rental	12,955
TOTAL	$237,055
Direct Labor Base (from the Payroll)	216,287
Indirect Factory Expense Rate	109.6%

On this basis the C.P.A. calculated a rate of 109.6 percent. The Auditor and Price Analyst used the same approach that the C.P.A. used and came up with a rate of 105.2 percent after applying the FAR provisions on the allowability of costs and applying judgment as to reasonableness. They agreed that the indirect costs were allowable and reasonable except for the allowance for uncollectible accounts of $6,000 and employee welfare of $3,500. FAR 31.205-3 states: "Bad debts, including actual or estimated losses arising from uncollectible accounts receivable due from customers and other claims, and any directly associated costs such as collection costs, and legal costs are unallowable." The $3,500 was spent on a company picnic which was for all company employees and their families. However, some company vendors and suppliers were also invited.

The Auditor confirmed the direct labor cost of $216,287. Both the Auditor and C.P.A. used the payroll record as their source of information.

The Auditor recommended that the TCO consider removing the Employee Welfare and Allowance for Uncollectible Accounts which would result in an Indirect Factory Overhead rate of 105.2 percent.

Other Costs

The Auditor also questioned $18,750 in interest charges on short term loans by the Fourth First Bank. Mr. Purola told the Auditor that if the Government had completed the contract or had originally terminated the contract correctly, the company would not have needed to borrow the money. But with this termination action now into its 14th month, the short term loans were needed.

General and

The C.P.A. calculated G&A expenses by using a method similar to that which

Administrative Expense	he used in calculating indirect factory expense. The C.P.A. developed a G&A pool for the Airmac Company's fiscal year which included all G&A expenses reflected on the books for the Company regardless of direct benefit to this or any of the other contracts. The C.P.A. then divided the total of the G&A pool by total manufacturing expense to arrive at a G&A rate of 25.6%.

G & A Expense	$212,819	= 25.6 %	G&A Rate
Total Mfg. Expense	$831,369		

As the Auditor examined the individual items of G&A costs allowed by the C.P.A., the following items were questioned:

1. Sales Commission	$ 22,546
2. Sales Office Expense	1,528
3. Financial Consultants (hired after termination)	20,061
4. Settlement Expenses (termination)	78,866
	$123,001

========

The Auditor recommends disallowing the questioned items of G&A but finds the base acceptable.

Profit	The Airmac Company is asking for 15 percent profit on the contract based on the fact that most of the work on the contract up to the point of termination was development effort. The Auditor did determine that had the contract continued to completion, Airmac would have made a profit. Therefore, it is up to the Government negotiating team to determine a fair and reasonable profit.
Settlement Expenses	The Auditor did not question the total amount of $78,866 claimed as settlement expenses.

Final Cost to the Government	To be determined at the negotiations after subtracting $117,508 in progress payments. **(NOTE: Do not bottom line negotiated price. Each cost element must be individually justified in the PNM.)**

AIRMAC COMPANY GROUP CASE

CONTRACTOR CONFIDENTIAL

Direct Material

The following is a revised list of direct materials used on the contract:

Revised Proposal	
Inventory	$121,450
Freight	6,675
Consumable Small Tools	3,875
Subcontractor Progress Payments	31,550
Total Direct Materials	$163,550

The $121,450 inventory figure includes interest charges of $6,238 on money borrowed at 14 percent to pay for materials The Government Auditor is questioning the interest charge.

The Government has also questioned $15,196 of the $121,450 inventory figure which represents material that could not be located. $8,877 of this inventory shortage has been located. A memo acknowledging this was received from Marie Landau, a Government Inspector (now deceased). See attached copy.

The C.P.A. made one more check to see if any other of the $6,319 of missing material had been located or accounted for y material control but the answer was no.

The DCAA Auditor is questioning freight charges of $6,675 as a direct cost of material since it has been company practice to charge all freight as an indirect factory expense. The C.P.A. checked and found that the freight charge of $6,675 was handled differently because it involved the cost of shipping fifteen heavy duty motors that were to be used specifically for this Government contract. Since this was a special shipment the C.P.A. decided that it should be identified as a direct material cost and charged to the contract as such.

The Auditor is questioning our claim of $3,875 for consumable small tools as a direct cost of material and wants us to carry this as an indirect factory expense. The C.P.A. says that they should be billed as a direct material cost since they were purchased for work on the contract. It was standard practice on this particular contract to charge everything purchased specifically for the contract directly to the contract. By charging directly to the contract it was possible to collect progress payments by simply presenting a paid bill for materials purchased as justification for the progress payments.

Direct Labor

The initial claim for direct labor was $160,742. The C.P.A. reclassified some labor costs and as a result submitted a revised direct labor settlement claim as follows:

Revised Proposal	
Manufacturing Labor	$ 62,962
Engineering Labor	25,122
Other Direct Labor	3,152

Material Handling Labor	14,631
Total Labor Costs	105,867

Examples of reclassified costs were such items as managerial salaries, vacation and holiday pay.

The claim for labor costs was developed by the C.P.A.'s examination of the time cards and payroll distribution records. When the payroll cards were checked, it was found that they were compatible with the distribution records. Therefore, the C.P.A. feels that this will serve to support the labor costs. The C.P.A. was concerned with the fact that very few shop orders or "Shop Travelers" describing what work was performed by a particular employee on a given component could be found. Thus, it was not possible to trace an employee's salary for a given week to work on a given component or components. The payroll records, however, did indicate the contract that the work was being performed on. This would at least identify the labor with the contract.

The Auditor questioned $3,427 of engineering labor costs claimed as engineering consultant services since these efforts could not be traced to the contract. If the Government pursues this issue, then the C.P.A. recommends that this cost could be moved to either the Indirect Factory Expense or General and Administrative Expense.

The C.P.A. was pleased to find that the charge of $14,631 as material handling charges was clearly justified. The Airmac Company had set up a separate warehouse for the purpose of handling all materials associated directly with the contract and payroll records clearly showed the amount of wages paid to the shipping and receiving clerks. The $14,631 represents the salaries paid to five employees. The Government Auditor accepted this as a reasonable amount considering the large number of components which had to be stripped from the Government-furnished units.

The C.P.A. put an amount of $3,152 in other direct costs since it was a fair grouping of miscellaneous direct labor costs. The Government Auditor also accepted these charges as reasonable.

Indirect Factory Expense

Indirect factory expense gave the C.P.A. a bad time. The problem centered around the fact that the Airmac Company attempted to charge all costs as direct costs, even those normally treated by accountants as indirect expenses. As a result no indirect factory expense pool was accumulated. After termination of the contract, the Government Auditor, the Government Price Analyst, and the C.P.A. each attempted to accumulate pools for indirect factory expense and general and administrative expenses. The C.P.A.'s approach was to calculate the direct labor base for the Company, calculate the indirect factory expense for the same period of time, and arrive at the indirect rate by dividing the labor base into the sum of the indirect factory expense pool.

Indirect Factory Expense

The C.P.A.'s indirect factory expense pool was proposed as follows:

Quality Assurance	$13,871
Rent	32,584

Repairs and Maintenance	14,372
Small Tools	6,475
Utilities	21,468
Travel	6,455
Employee Welfare	3,500
Depreciation	11,449
Holiday & Vacation Pay	7,191
Indirect Labor & Materials	56,979
Auto & Truck Expense	3,395
Insurance	6,723
Indirect Freight	5,516
Taxes (Payroll, Property, etc.)	28,122
Allowance for Uncollectible Accounts	6,000
Equipment Rental	12,955
TOTAL	237,055
Direct Labor Base (from the Payroll)	216,287
Indirect Factory Expense Rate	109.6%

Due to the fact that the C.P.A. was unable to trace quality assurance, inspection, and maintenance and repair costs, it was decided that all such costs would have to be classed as indirect costs. Generally accepted accounting practice would allow such items of cost to be classified as direct costs as long as they could be specifically identified as a part of the contract effort. After completing the cost break-out and setting up the indirect factory expense pool, the C.P.A. ran a total and came up with a rate of 109.6 percent of direct labor.

The C.P.A. found that the Auditor had accepted all costs except for two (Employee Welfare and Allowance for Uncollectible Accounts). The $3,500 was spent on an annual company picnic which was for all company employees and their families. Also invited out of courtesy were company vendors and suppliers, but only a few of them took advantage of the invitation. Therefore, the C.P.A. feels that this is a reasonable and allowable cost. The C.P.A. also feels that the Allowance for Uncollectible Accounts is reasonable because the company's bad debt should be absorbed by all the firm's contracts, including the government contract, and not just Airmac's non-government business.

Other Costs

The Auditor also questioned $18,750 in interest charges on short term loans by the Fourth First Bank. Mr. Purola told the Auditor that if the Government had continued the contract or had originally terminated the contract correctly, the company would not have needed to borrow the money. But with this termination action now into its 14th month, the short term loans were absolutely necessary to keep the company in operation.

General and Administrative Expense

The C.P.A. calculated G&A expense by using a method similar to that which was used in calculating indirect factory expense. The C.P.A. developed a G&A pool for the Airmac Company's fiscal year which included all G&A expenses reflected on the books for the company regardless of direct benefit to this or any of the other contracts. These expenses were as follows:

1. Sales Commissions	$ 22,546
2. Executive Salaries	66,300
3. Sales Office Expenses	1,528
4. Settlement Expenses (termination)	78,866
5. Office Secretaries	23,518

6. Financial Consultants	
(hired after termination)	20,061
TOTAL G&A COST	212,819

After the C.P.A. arrived at this total figure, the C.P.A. divided the total of the G&A pool by total manufacturing expense to arrive at a G&A rate of 25.6%.

$$\frac{\text{Company wide G\&A expense}}{\text{Total Mfg. expense}} \quad \frac{\$212{,}819}{\$831{,}369} = 25.6\%$$

The application of this method resulted in the following rate:

The Auditor has indicated that there were questions with items 1, 3, 4 and 6 in the $212,819 G&A pool but that the $831,369 base is acceptable.

Profit

The Airmac Company is asking for 15 percent profit on the contract based on the fact that most of the work on the contract up to the point of termination was development effort. Had the contract continued to completion, Airmac would have made a profit. When the original contract was signed, Mr. Purola had felt they would make a profit of over 12 percent on the business.

The Auditor indicated that the proposed settlement expense of $78,866 was acceptable.

Final Amount To Be Received

To be determined at the negotiations after subtracting $117,508 in progress payments.

Requirement

Conclude negotiations with the Government today. Although the firm want to recoup as much of their costs as possible, it is imperative that the negotiations do not end in deadlock. The company has been waiting more than one year for the Airmac settlement and needs the money now.

United States Government Memorandum

SUBJECT: Airmac Company Contract No. AMI-82240-8X-TH-516

Missing material inventory in the amount of $8,877 has now been located and inspected by the Government.

Marie Landau
Government Inspector

cc: Airmac Company
2000 Buck Boulevard
Los Angeles, CA 90000